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PROBLEMS OF THE ADOPTION OF THE EURO IN LITHUANIA

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Abstract. The paper analyzes the possible consequences for Lithuania and other Eastern European countries after joining the European Monetary Union and adopting the single currency, i.e. the euro. The international importance of the euro, the advantages and disadvantages of the single currency are discussed. The experience of Slovenia and Germany is analyzed. The investigation has shown that the adoption of the euro did not have a considerable influence on the price level in Germany. Actually, the adoption of the euro caused a rise in some prices to a certain degree but this influence was insignificant. Due to the proper means applied, Slovenia also avoided a sharp jump in prices after the national currency was replaced by the euro. However, due to psychological factors the concerns about the increase in the prices after the adoption of the euro may become exaggerated. The strategy of the adoption of the euro in Lithuania is discussed with regard to the experience of other countries.

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Keywords: euro, European Union, inflation.
Reikšminiai žodžiai: euras, Europos Sąjunga, infliacija.

Introduction

The adoption of the euro and joining the European Monetary Union (EMU) still remains one of the most important tasks of economic policy in Lithuania. It has been anticipated that Lithuania and Slovenia should have become euro zone countries since 1 January 2007. However, by that moment the inflation rate in Lithuania slightly exceeded the set limit (0.1 %), and Slovenia alone joined the EMU. The situation in Lithuania in 2007 proved that the decision of the European Central Bank (ECB) was grounded, since Lithuania failed to meet the requirements regarding economic stability. Thus, the adoption of the euro in Lithuania was postponed. In order to select the proper strategy for the integration into the EMU, it is important to consider the advantages and disadvantages of a single currency as well as the economic potentiality of the country and to analyse the experience of the countries that successfully joined the EMU. Since the experience of the functioning of the EMU in Europe is not so rich, more discussions on this point are expected in the future. The ways the adoption of a single currency can affect country's economy have not been much investigated in Lithuania, though this problem gets sufficient attention abroad. From foreign authors Benjamin (2007), Duisenberg (2002), Galatis, Tsatsaronis (2003), Gaspar (2004), Greenspan (2001), Hartman et al. (2003), Rose (2001), Shalder (2005), and others are worth mentioning. In Lithuania these problems are widely investigated only by Kropas and Kropienė (2005).

The purpose of the present article is to discuss the process of the adoption of the euro in Lithuania. The main task is to investigate the possibilities to adopt the euro in Lithuania with reference to the experience of other countries that successfully joined the EMU. Methods of the present research include

systemic analysis of scientific literature and the analysis and generalization of statistical data.

1. The Main Historical Moments in the Foundation of the European Monetary Union

The European integration process, the result of which is the foundation of the European Union (EU), is one of the most politically and economically significant processes in the entire history of Europe. Considering economic aspects, the establishment of the EMU was the most important task after the establishment of the EU. As early as in 1956 the idea of the establishment of the EMU was already discussed in the negotiations on the Rome treaty, and the monetary union formation plan was approved by the Maastricht treaty, signed on 7 February 1992. Two main moments in the process of the creation of the EMU should be mentioned. The first is the Werner's report in which he suggested creating this union until 1980, referring to the currency system consisting of the currency basket (ecu) and the exchange rate mechanism. The second is the Delors report, the main focus of which is on the plan for creating the EMU defined by the Maastricht treaty.

Formally, the Economic and Monetary Union has been existing since 1 January 1999, and the euro as a currency started functioning in the twelve states of the EU in 1 January 2002. The introduction of the euro ended the currency integration process which had lasted for 50 years. The euro became the key axis of integration. In the context of the international monetary system, the formation of the EMU is perhaps the most important event since the failure of the world monetary system that functioned on the basis of the Bretton Woods treaty. The first year of the functioning of the euro has shown that the single currency stabilized the fluctuation of interest, price, and exchange rates in a complicated environment of economic globalization. Noteworthy is the fact that the functioning of the EMU is based on new ideas: in the monetary policy of the EMU preference is given not to the stimulation of economic growth by the classical monetary policy means, but to the guarantee of long-lasting price stability.

In comparison to other monetary unions, the Euro project is an event of particular importance in the monetary history. Never before did a group of independent states refuse their national currency and, concurrently, retain political independence. This fact determines quite a new combination of macroeconomic policies, based on general values and following the subsidizing principles. A policy based only on national interests can be neither productive, nor stable enough. A policy based on a single currency has an effect on all the spheres of economics: the allocation of resources and revenues, the economic growth, as well as the labour, product, service, and finance markets. The adoption of the euro is significant not only in economic and political but also in psychological terms. National currency is an important symbol of national sovereignty. A voluntary change of national currency into the euro indicates the strengthening of the general European identity.

When on 1 January 2007 Lithuania was expected to join the EMU, the euro zone already consisted of 12 EU member states. In the same year Slovenia and later on Cyprus together with Malta and Slovakia joined the EMU; today it unites 16 EU member states.

2. International Role of the Euro

The introduction of the euro on 1 January 1999 was of great significance not only to the EU, but also to all the states in the world. Having replaced the national currencies of most EU member states, the euro was continuously gaining strength and, eventually, became one of the most important international currencies in the world. At present, the euro can be regarded as the second world currency, successfully competing with the U.S. dollar. The role of the euro as the basic and reserve currency is also increasing (The international role of the Euro, 2007). The euro being the basic currency, a wide spectrum of currency regimes is possible. One way or another, about 30 non-euro-zone states have pegged their currencies to the euro, though they make up a rather small part of the general gross world product (Benjamin, 2007). Some countries use the euro as the local currency (e.g. territories under the jurisdiction of France), currencies of other countries are pegged to the euro (e.g. Lithuania), yet another group of countries linked their national currencies to a currency basket, one component of which is the euro or its national denomination (e.g. Hungary, Ireland). One more group of countries (the Czech Republic, Poland, Slovakia) keeps to the policy of the controlled exchange rate. Thus, one of the outcomes of the establishment of the EMU is the internationalization of the euro. An obstacle for a more rapid spread of the euro is the so-called "snitching cots", i.e., the consumption of time and money for the transition to another currency.

The introduction of the euro was a powerful stimulus for the development of financial markets. During the first three years since the introduction of the euro, the financial turnover in the euro zone countries has grown more than twice in comparison to that of the national currencies. The single currency made it possible to optimally distribute the capital in the euro zone. Due to this, more participants could make use of a larger number of financial means, because in smaller states with different currencies there is no possibility to form the sufficient critical mass of using certain financial means.

Though the U.S. dollar remains the principal investment currency, its significance is declining, while that of the euro is increasing. The percentage of bonds and money market funds denominated in euro has grown from 18% in 1998 to 31% in 2004 in the international market, while the percentage of those denominated in U.S. dollars has decreased from 48% to 42% (Hartman, 2003). The Eurobond market is one of the target ones in the world. According to the data of banks, what regards international settlements, bonds issued in euros in 2004 made up 48% of all international bonds, while bonds issued in U.S. dollars comprised 34%. Bond markets of the EU and the U.S. governments are similar, but the bond market of the corporations of the latter is much larger. The main aspects that determine the international attractiveness of the euro as an investment currency are as follows: the integrated, so-called "deep" market in which a large amount of financial means can be purchased and sold without any influence on their price; a developed secondary market; a great variety of financial means; a high degree of market liquidity. After the adoption of the euro, the risk of exchange rate has disappeared and competition increased; this stimulates further integration of financial markets and increases their efficiency.

In recent years, the tendencies of integration and competition in international financial markets have been observed, because the world finance centers were competing for influence in international financial markets. The EMU and the euro precondition the strengthening of the positions of the EU as an international canter of finance in comparison with the U.S. and Japan. The adoption of the euro also had an effect on the domestic financial market of the EMU (Galati, 2003). After the introduction of the single currency, transactions in national currencies have disappeared in the states belonging to the EMU; so did the necessity of transactions for insuring against the exchange rate risk. Thus, the euro integrated and consolidated financial markets of the EMU states. The effect of the adoption of the euro on financial markets is much stronger and faster than on the other fields of economy (Gaspar, 2004; 2003).

After the adoption of the euro, the fastest changes took place in the markets of short-term financial means, i.e. money. The euro stimulated the integration of the money market and the technological progress of settlements. As a consequence, there are no great differences in interest rates. The integration of long-term financial means markets required more time. Naturally, there also were some changes in the markets of shares and bonds; however, the changes were not as fast as in the exchange markets. The influence of a single currency on Eurobond markets manifests itself in three ways:

1) it expands these markets and increases their liquidity;

2) it invokes structural changes in the market, and

3) it transforms the state loan market.

There is no more currency risk in the euro zone; therefore, investors can pay more attention to the loan risk and its evaluation. The wider and more liquid market of Eurobonds becomes more and more attractive to investors even beyond the borders of the euro zone. The former national markets were small, non-liquid and, therefore, unattractive for large international investments. The effect of the euro on stock markets is weaker than on other segments of the financial market: the experience shows that issuers concentrate issues in the national markets that frequently become most liquid. Selection of a market is determined not so much by a currency as by other factors, e.g. geographical spread of the issuer's activity. The removal of currency risks has not essentially changed the relations among the issuers and their national markets. The adoption of the euro determined structural changes in the European markets of derived financial means and their expansion. The euro has a double effect on the markets of derived financial means. Firstly, the single currency diminished the variety of derived means, since some kinds of transactions have disappeared. On the other hand, due a decrease in the number of transactions, the competition between the EU derived financial means intensifies.

The adoption of the euro also invoked changes in the international monetary system stimulating currency integration in other regions of the world. The euro became the second currency in the world according to the size of the economies in which it is used as well as the size and liquidity of capital markets (Greenspan, 2001).

3. Influence of the Euro on the Economic Processes in the World

The adoption of the euro was very significant not only for the EU countries but also for all the countries in the world. One of the major advantages for countries joining the EMU is a positive effect of trade expansion, i.e. the so-called Rose effect (Rose, 2001). Andrew Rose has defined that trade flows between pair-countries that belong to a monetary union are on the average 100% greater than among the EU countries not belonging to a monetary union. It is also important that trade expansion does not take place at the expense of trading with other countries, i.e. it does not diminish the trade volumes. Empirical data of the EU also support the conclusions of these investigations. After establishing the EMU, its internal trade volume increased by about 10% in comparison with other EU member states. This effect is supposed to continue for as least 20 years, and the trade volume may increase by about 60%. Noteworthy is the fact that trade growth stimulates economic growth. It has been established that a trade increase by 1% determines an increase in the country's gross domestic product by 0.33 %. As estimated by the international currency fund, the adoption of the euro in the EU will determine the increase in the gross domestic product of up to 20 - 25% in the pending 20 years (Shalder, 2005).

By eliminating the exchange rate indetermination, the single currency diminishes risk and, thereby, determines a lower rate of real interest. The decreasing rate of interest, in its turn, stimulates economic growth. After the adoption of the euro, there is no expenditure related to the exchange rates between the euro and the national currency. This factor also influences the size of the gross domestic product. In the opinion of the Commission, the elimination of transactions costs may increase the EU gross domestic product by 0,25% - 0,5 %. Such an increase is not so little; what is more, this is not the only effect. The advantage of joining the euro zone is not one-sided. Positive impacts are experienced not only by the new EMU countries, but also by the countries in the entire euro zone. However, for the euro zone countries the advantages are greater. The use of the integration into the euro zone manifests itself via trade expansion, via the integration of the finance sector, and via the growth of the international role of the euro. It must be stressed that the integration into the euro zone provides superiority to a country, i.e. an opportunity to actively represent own economic interests by participating in the EU economic decision-making. It is the countries belonging to the euro zone that govern the principal economic decisions. The remaining EU countries have little possibilities to influence these decisions.

One of the arguments against the adoption of the euro is based on the Balassa-Samuelson effect: the growth of productivity in open sectors is more rapid than in the closed ones, since the former attract more foreign investments receptive to technologies. Increasing wages and salaries due to the growth of productivity enforce the growth in closed sectors too. In order to maintain the profit obtained, the prices in closed sectors must be increased. Thus, the Balassa-Samuelson effect means the growth of inflation within a country. As estimated by the International Monetary Fund, the Balassa-Samuelson effect can increase inflation by 1% – 2 % in the EU states, if they participate in the second exchange rate mechanism (Shalder, 2005).

The countries that pursue the classical monetary policy lose this independent economic policy means after joining the EMU. The Central European Bank pursues the monetary policy with regard to the situation of the entire euro zone without stressing the particularities of separate countries. Therefore, the common monetary policy can be regarded optimal in respect of separate countries. However, such deviations should not be considerable because the common EU internal market, free movement of communities, services, and capital also stipulate the common economic tendencies in all the countries of the EMU. This argument does not apply to those countries in which the monetary board model is applied or the currencies of which are pegged to the euro. These countries have no real monetary policy leverages; therefore, in this respect an entry into the EMU would not invoke any negative consequences.

The countries in which the monetary board model is applied acquire certain advantages in the convergence process, since the requirements for the exchange rate stability are realized automatically. However, the Board of Directors of the Central European Bank has declared an official opinion that the Board of Directors is not a substitute for the participation in the 2nd exchange rate mechanism (Duisenberg, 2002). On the other hand, in the opinion of many experts, the monetary board of directors and the obligatory two year participation in the 2nd exchange rate mechanism is the best exchange rate policy (Gulde, 2000; International Monetary Fund, 2004). It is of interest to note that the investigation performed by the experts of the International Monetary Fund has shown that economies of the countries with monetary management were growing much faster than the economies of other candidate-

member countries (Ghosh, 1999). Consequently, the mode of monetary management is a factor stimulating the convergence process.

If the majority of the countries of Eastern Europe were accepted to EMU today, they would not avoid of the price "shock", i.e. a fair jump in prices. Even the most developed Western and Eastern countries, e.g. Germany, have not avoided a certain increase in prices, though it was not considerable. The higher is the increase in prices, the lower are the economic indices (in comparison to the average indices of the majority of the developed countries). This rule especially applies to the level of prices and wages (salaries). The countries seeking to join the EMU must participate in the 2nd exchange rate mechanism at least for 2 years, under the requirements of the Maastricht treaty. It is possible to prolong the period; however, the experts agree that it is not reasonable since that can cause certain tension and impede an efficient activity of the monetary union. That is why the most reasonable solution is to join the 2nd exchange rate mechanism when a high degree of convergence is reached and the economic indices reach the EU average.

Psychological factors are also of utmost importance for the adoption of the euro. Just like the national anthem or a flag, the national currency is perhaps the most vivid indication of sovereignty. Loss of a right to issue the national currency can cause a negative attitude of the population to the adoption of the euro. In many cases, however, such an attitude is merely a psychological factor without any economic grounds, e.g. if the national currency is not so strong, its rate is unstable, or it is pegged to the currency of another country.

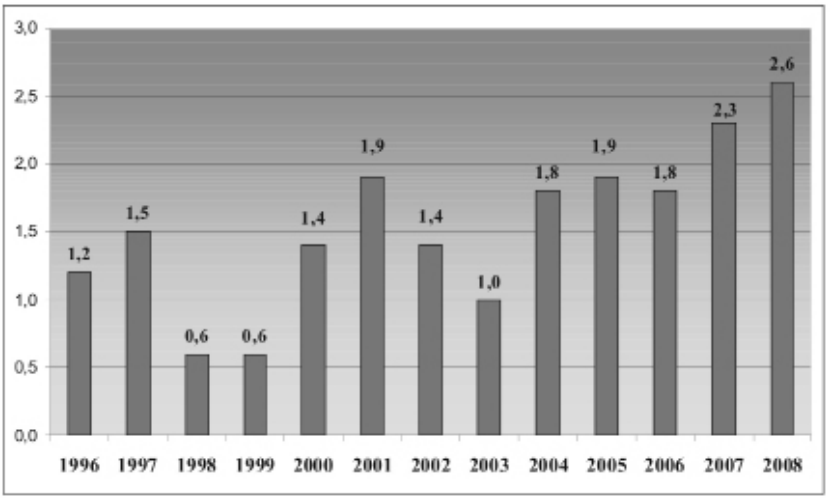
In summary, we can affirm that, in the terms of economics, the adoption of the euro undoubtedly causes more positive than negative effects.

4. Generalization of the Experience of the Countries that Successfully Joined the EMU

The experience of the countries that successfully joined the EMU is rather important to the countries of Eastern Europe seeking to join this union. The EU states that are not yet members of the EMU do not consider whether to adopt the euro or not, because, subject to the Maastricht treaty, they undertake the obligation to become the members of the monetary union. On the other hand, introduction of the single currency would give these countries more advantages than disadvantages. It is important, however, to select the proper strategy for the convergence process.

An analysis of the experience of Germany can provide answers to some questions regarding the selection of the convergence strategy. Despite the fact that Germany is one of the most powerful European states, having a strong economy, fears regarding the adoption of the euro were not avoided. Most people expected an abrupt rise in prices, though economically such fears were not grounded. In fact, statistical data indicated a certain rise in prices after the adoption of the euro in Germany, but it was not as large as perceived by the mass media and the residents themselves. Besides, the rise in prices was conditioned by other factors not related with the adoption of the euro. The Federal Statistical Office of Germany has conducted an analysis and concluded that the adoption of the euro influenced the prices of several services and commodities; however, no notable influence on the common price index of users was observed. According to the data of the Federal Statistical Office of Germany (Fig. 1), the price level after the adoption of the euro has increased.

1. Fig. The dynamics of the price level in Germany (%) during 1996 - 2008



Source: http://www.destatis.de

In the period of 2002 – 2006 the highest inflation level was 1.9% (except for 2007), i.e. it did not exceed the limit set by the Central European Bank. The results of the investigation led to the following conclusions:

rounding up of prices when replacing marks by the euro has raised the price level to some extent;

the price of several goods and services, e.g. tickets to cinema theatres, chocolate, engine oil, services of hairdressing and chemical cleaning, has grown considerably;

on the other hand, the prices of some long-lasting goods (television sets, cameras) or some foodstuff (coffee beans, milk, butter) significantly decreased.

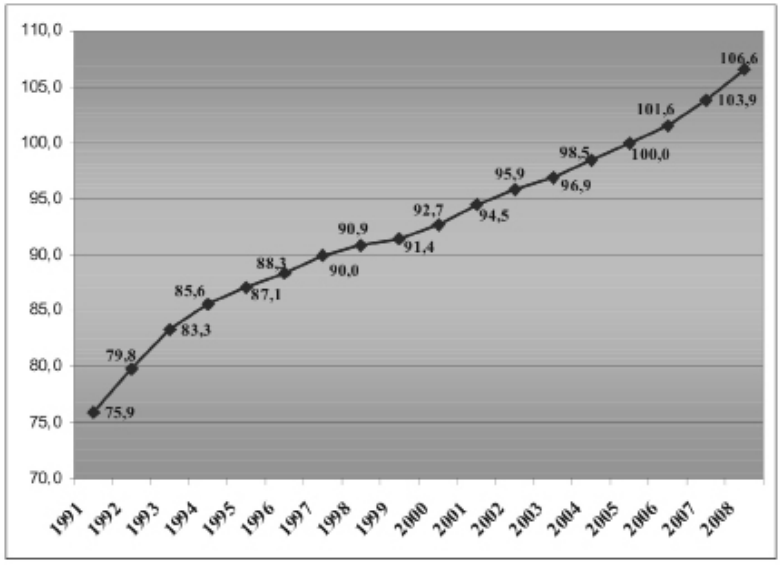
The analysis made by the Deutsche Bundesbank has shown that in two years after the adoption of the euro the price rise was stopped; however, a variety of prices increased considerably (http://www.bundesbank.de).

Other factors, not related to the adoption of the euro, were much more significant. These are: reform of ecological tax in 2002 – 2004, health care reform in 2004 that conditioned the general rise in prices of services, increasing taxes for tobacco products. All these factors influenced the general increase of the price index. However, the greatest impact on the inflation level was made by the growth in fuel prices (gas, electricity, heating); fuel prices increased by 25% – 30% in the period 2002 – 2006. In 2007 and 2008 the price jump was determined by a further rise in the price for energy products and food. According to the Federal Statistical Office of Germany, common index of consumers' price increased by more than 10 % during this period (Fig. 2).

Psychological issues also must be considered in estimating the adoption of the euro as a factor of price rising. People subjectively estimate information on a certain economic phenomenon, and that estimation not necessarily corresponds to facts. Users tend to notice and stress price growth rather than price fall or its stability. It has been observed that even after 3 - 4 years since the adoption of the euro in Germany, people are still comparing prices in euros with the former prices in German marks. With regard to such a situation, the Federal Statistical Office of Germany decided to follow the honesty principle, i.e. to objectively inform the society about the changes in the price index, inflation level, etc. This strategy of communication proved to be effective and has been accepted in the international arena.

Slovenia was the first among the new EU members to adopt the euro and in 1 January 2007 it became the 13th member of the EMU. Lithuania also planned to join the EMU together with Slovenia; however, due to the inflation level that exceeded the set limit (only by 0,1%) such plans had to be postponed. Slovenia prepared to this event with great responsibility by considering the experience of other countries. First of all, in comparison to other Eastern Europe countries, economic indices in Slovenia have closely approached the European level; this ensured a smooth entry into the euro zone without any major economic shocks. Since March 2006, double price marking, i.e. in euros and in the national currency, has been introduced in Slovenia. The working people were informed about their wages and salaries in euros. An intensive society information campaign was carried out. About 500 enterprises signed a covenant not to raise prices. After 1 January 2007, the Consumer Association of Slovenia started blacklisting tradesmen and service providers. These blacklists included subjects who raised prices of commodities or services by more than by 6%. The society actively joined this campaign and their reports were an important additional source of information. All these measures made it possible for Slovenia to avoid a greater jump in prices after the adoption of the euro.

2. Fig. Growth of the consumers' price index in Germany (%) during 1991-2008



Source: http://www.destatis.de

4. The Principles of the Strategy of the Adoption of the Euro in Lithuania

The experience of the euro zone countries showed that an increase in prices for goods and services is probable in the initial stage of the process of the adoption of the euro due to possible attempts of businessmen and pro-

duction suppliers to round up prices in their favour. Such a situation is possible in Lithuania, as the litas is associated with the euro at 3.4528 to 1. It is very important to properly evaluate and prevent such a threat when the process of the adoption of the euro starts. The key role should be played by the Consumers Association and citizens, whose activeness and concernment are very important.

The Commission for the Coordination of the Adoption of the Euro in the Republic of Lithuania (the Commission) was formed in accordance with the Government Resolution No. 592 of 30 May 2005. The task of the Commission is to ensure proper adoption of the euro in Lithuania. Seven working groups have been set up to reach this task; the responsibilities of the groups included the preparation of the National Changeover Plan (The Plan) and proper familiarization of public with the Lithuania's Public Information and Communication Strategy for the Adoption of the Euro (the Strategy). The Plan and the Strategy started to be implemented on 25 April 2007. The aim indicated in the Plan is to establish the major elements of the changeover in Lithuania, to foresee the necessary measures for the protection of consumer interests, to ensure a smooth changeover process and public awareness. Working groups responsible for the preparation of the Plan consisted of the institutions of the Government of the Republic of Lithuania, the Bank of Lithuania and representatives from consumers', employers' and business associations assigned for the research of different issues related to the adoption of the euro in Lithuania. It is stated in the general provisions of the Plan that it establishes major elements and principles of the adoption of the euro and preparation for the changeover; responsibilities of separate sectors and necessary measures ensuring the protection of consumer interests are also indicated in the general provisions of the Plan. The Plan establishes the key elements of the adoption of the euro, its scenario and timetable. The plan also covers legal and institutional frameworks, rules for exchange and conversion of the litas into the euro together with the measures to be implemented in different sectors.

The Strategy uses the following principles as the basis of the changeover in Lithuania. Continuation principle means that all transactions with references to the litas will be further valid after the exchange of the litas into the euro. A value in litas will mean a value converted into the euro according to the irrevocably fixed conversion rate between the euro and the litas. Another principle is the protection of the consumers' interests which means that all possible measures will be taken in order to avoid abuse in recasting prices, wage, pensions, social payouts, etc. during the changeover process. The expenditure of the economic entities related to the preparation and adoption of the euro will be not reimbursed. The total costs of preparation for the changeover, i.e. for minting of euro coins, exchanging of litas banknotes and coins into euro banknotes and coins, restructuring of payment systems, etc. will be financed from the funds of the Bank of Lithuania. The expenditure of the Government institutions related to the adoption of the euro will be covered by the general assignations of the institutions.

The major aim of the Strategy is to ensure public awareness regarding the processes of the adoption of the euro and the consequent factors. The information about the impact of the single currency on national economy, principles of conversion of accounts, balances and social payouts from litas into euro, nominal of the euro banknotes, banknote security features and other changeover conditions will be provided by the institutions interested. The provided information should be sufficient and should properly and timely prepare the society for the changeover. Thus, the strategy of the adoption of the euro in Lithuania was developed taking into account the practices of the euro zone countries.

Conclusions

With reference to the results of the present analysis, the following conclusions can be made.

A single currency contributes to the stabilization of the economy. During the period of economic instability the euro plays the role of the financial anchor to the countries of the EMU. Today's economic processes show that the countries of the EMU are less influenced by the economic downturn and are the first to emerge from it. The reason for this is not only their general economic strength but also the stabilizing role of the euro. What is more, a single currency would be very contributory to the countries of Eastern Europe including Lithuania emerging from the economic downturn.

The statistical analysis of the price level dynamics in Germany shows that the adoption of the euro did not have a significant effect on the prices. Though this conclusion is not applicable to the countries with a weaker economy; price shock is inevitable for them due to the existing conditions for the adoption of the euro. Thus, the Maastricht criteria set out for the candidate countries are absolutely fair as by meeting it candidate countries would increase their economic index to the European level and smoothly integrate into the euro zone.

The Lithuanian currency board model could be considered as an advantage in this case, as it automatically meets one of the Maastricht's criteria: the stability of the national currency in relation with the euro. Joining the euro zone is seen as one of today's major tasks for Lithuania; therefore, it is expected that the present currency board model will not be rejected before joining the EMU. Consequently, this means that the litas will not be devaluated even though opposite opinions on this issue also exist.

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EURO ĮVEDIMO PROBLEMOS LIETUVOJE

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Straipsnio tikslas – įvertinti galimus euro įvedimo Lietuvoje padarinius bei išnagrinėti būtinas priemones eurui įvesti, įvertinus užsienio šalių, sėkmingai įsivedusių eurą, patirtį. Straipsnyje aptariama euro reikšmė tarptautinių finansų rinkų plėtotei bei bendros valiutos pranašumai ir trūkumai. Nagrinėjama Vokietijos ir Slovėnijos patirtis įsivedant eurą. Remiantis statistikos duomenimis analizuojama kainų lygio dinamika Vokietijoje, nustatant įvairių veiksnių įtaką infliacijos augimui, tarp jų ir euro įvedimo įtaką kainų lygiui. Aptariama Lietuvos strategija įsivedant eurą.

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Gedinimas Davulis – Mykolo Romerio universiteto Ekonomikos ir finansų valdymo fakulteto Ekonomikos katedros profesorius, habilituotas daktaras. Paskelbė daugiau kaip 80 mokslo darbų. Pagrindinės tyrimo sritys – makroekonominių procesų modeliavimas ir tyrimai, viešojo sektoriaus ekonomika, ekonomikos ir transporto vadyba, optimizacijos metodų taikymas ekonomikoje.